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August 31, 2005

Marlene H. Dortch  
Secretary  
Federal Communications Commission  
The Portals  
445 – 12<sup>th</sup> Street, SW  
Washington, DC 20554

**Re: SBC/AT&T Application – WC Docket No. 05-65;  
Verizon/MCI Application – WC Docket No. 05-75**

Dear Ms. Dortch:

On August 1, 2005, SBC and AT&T (“Applicants”) submitted another attempt to obfuscate the real and very crucial competitive concerns that arise from their proposed merger.<sup>1</sup> This response is submitted on behalf of Conversent Communications, NuVox Communications, TDS Metrocom, and XO Communications (“Joint CLECs”). Because there have been numerous *ex parte* filings by the Applicants and the Joint CLECs debating the many issues in dispute, we believe it is time to review these filings in the context of time-tested legal and economic standards and methodology applicable to merger review and tally the score. As is plainly evident, the Applicants have refused to meet these standards and methodology. Under well established Commission precedent, the Applicants have the burden of proving their case. To date, all they have done is swing and miss.

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<sup>1</sup> Letter from Gary Phillips of SBC and Lawrence Lafaro of AT&T to Marlene Dortch of the FCC, dated August 1, 2005, and filed in WC Docket No. 05-65 (“*Applicants’ August 1, 2005 Letter*”). In their Application, Joint Opposition, and *ex parte* filings, Verizon and MCI have made arguments and claims and have submitted data similar to that filed by SBC and AT&T. To the extent that they are similar, this filing by Joint CLECs is equally applicable.

## Legal Standard and Methodology for Review

Sections 214(d) and 310(d) of the Communications Act require the Applicants to demonstrate that the proposed transfer of control “would serve the public interest, convenience, and necessity.”<sup>2</sup> Just one month ago, in issuing its decision in the *Western Wireless/ALLTEL Merger*, the Commission concluded that this standard includes a “deeply rooted preference for preserving and enhancing competition in relevant markets.”<sup>3</sup> The Commission held, “In addition to considering whether the merger will reduce existing competition, therefore, we also must focus on whether the merger will accelerate the decline of market power by dominant firms in the relevant communications markets and the merger’s effect on future competition.”<sup>4</sup>

Based on these standards, the Commission detailed the methodology for conducting the competitive analysis portion of the public interest review:

We begin by determining the appropriate market definitions...We then measure the degree of market concentration. Next, we consider the possible competitive harms that could occur due to a significant increase in market concentration or market power<sup>5</sup>...Mergers may create market power in a single firm and allow that firm to act on its own in raising prices, lowering quality, reducing innovation, or restricting deployment of new technologies or services. A merger may also diminish competition if it makes the firms selling in the market more likely to engage in coordinated interaction that harms consumers.<sup>6</sup>

The Joint CLECs intend to use the Commission-prescribed methodology in reviewing the filings to date by the Applicants and themselves to demonstrate again (based just on the competitive analysis and not other public interest failings) that this proposed merger – as well as the proposed merger of Verizon Communications Inc. and MCI, Inc. – does not serve the public interest, convenience, and necessity.

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<sup>2</sup> 47 U.S.C. §§214(a), 310(d).

<sup>3</sup> *In the Matter of Applications of Western Wireless Corporation and ALLTEL Corporation For Consent to Transfer Control of Licenses and Authorizations* (File Nos. 0002016468, et al.), Memorandum Opinion and Order, WT Docket No. 05-50, Released: July 19, 2005, ¶19 (“*Western Wireless/ALLTEL Merger*”).

<sup>4</sup> *Id.* ¶20.

<sup>5</sup> “Market concentration is generally measured by the Herfindahl-Hirschman Index (“HHI”) and changes in concentration are measured by the change in HHI.” *Id.* ¶23.

<sup>6</sup> *Id.* ¶24.

## Competitive Analysis Methodology

### I. Market Definition

As noted by the Commission, market definition is the necessary first step in any application for review of a merger. Yet, astonishingly, more than six months after the proposed merger was announced, the Applicants refuse to define any relevant markets for wholesale access services. This simple fact ends any reasonable review of the merits of their antitrust analysis. Presumably, the Applicants know that any plausible market definition results in highly concentrated markets with large increases in market concentration caused by the proposed merger.

In contrast to the Applicants refusal to set forth a market definition, the Joint CLECs have provided alternative product market definitions for Metropolitan Service Areas (“MSAs”) and for smaller areas based on the level of building demand.<sup>7</sup> For instance, markets defined as consisting of relatively high building demand, e.g., DS3 or OC3, comprise the high-density portions of large cities, and the HHIs that result are not affected by SBC’s presence in low-density areas of MSAs.

### II. Assigning Market Shares and Calculating the Resulting HHI (Market Concentration)

Applicants take the position that assigning market shares and calculating HHIs is “simply irrelevant.”<sup>8</sup> They disparage HHI statistics as being “static” in nature and have refused to provide their own HHI statistics, despite their claim to have superior data with which to assign firms’ market shares.<sup>9</sup> Instead, the Applicants rely on imprecise and insufficient data – essentially anecdotal references -- to offer the vague, conclusory rubric that “there is ample competitive supply from many other competitive providers.”<sup>10</sup>

The position of the Applicants stands in stark contrast to the position set forth in the *U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines*, which state: “In evaluating horizontal mergers, the Agency *will* consider both the post-merger market concentration and the increase in concentration resulting from the merger. Market concentration is a useful indicator of the likely potential competitive effect of a merger.”<sup>11</sup> Further, it is clear that the *Horizontal Merger Guidelines* provide for a “forward-looking inquiry”<sup>12</sup>. Hence, the Applicants’ criticisms of the HHI statistics as static and irrelevant are wrong as a matter of law

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<sup>7</sup> See *Wilkie Ex Parte Presentations*, June 15, 2005, pp. 2-6, 13-18, and August 1, 2005, pp. 8, 10.

<sup>8</sup> *Applicants’ August 1, Letter*, p. 4.

<sup>9</sup> *Id.* at Appendix B, p. 6.

<sup>10</sup> *Id.* at Appendix B, p. 6.

<sup>11</sup> U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines” (revised 1997) (*“Horizontal Merger Guidelines”*), § 1.51 (emphasis added).

<sup>12</sup> *Id.* § 0.

and merger review practice. In contrast to the steadfast refusal of the Applicants to provide HHI statistics, the Joint CLECs have provided HHI statistics for numerous MSAs and different building types (by demand) within MSAs. Each of these show that both proposed mergers increase concentration far in excess of the Department of Justice's benchmarks.<sup>13</sup>

In addition, the Applicants' unsupported assertion that if a building is served or could be served by another CLEC, the proposed merger cannot have anticompetitive effects is simply incorrect.<sup>14</sup> For example, if one other CLEC were connected to an AT&T on-net building, then the merger would reduce the number of suppliers of wholesale local access to that building from three to two, which certainly raises the possibility of anticompetitive effects. Properly calculated HHI market concentration statistics are the necessary first step in the competitive analysis precisely because they summarize the size distribution of all the firms in the relevant markets.

Finally, the Applicants' reliance on the Commission's impairment standard from the Triennial Review proceeding to determine committed entry is misplaced.<sup>15</sup> The Commission, in fact, rejected the use of the *Horizontal Merger Guidelines* to determine impairment – a proposal most forcefully offered by AT&T<sup>16</sup> – in its Triennial Review decision:

We reject the arguments that we should require the unbundling of network elements to remove an incumbent LEC's market power...and that we should use the HMG to identify market power. The purposes of a market power analysis are not the purposes of section 251(d)(2). While this antitrust analysis attempts to determine whether market participants would be able to exercise market power and raises prices above competitive levels if a merger were consummated, the Act requires only that network elements be unbundled if competing carriers are impaired without them...<sup>17</sup>

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<sup>13</sup> *Wilkie Ex Parte Presentations*, June 15, 2005, pp. 13-15, and August 1, 2005, pp. 8, 10. Joint CLECs understand there may be flaws in the GeoResults data but have no reason to believe the flaws are significant enough to alter materially the dramatically increased concentrations. In any event, if the Applicants have better data on building demand and supply, they have to date refused to use it to present their own market share and HHI statistics.

<sup>14</sup> *Applicants' August 1, Letter*, Appendix B, p. 2.

<sup>15</sup> *Applicants' August 1, Letter*, pp. 5-6.

<sup>16</sup> *See*, Ex Parte Letters filed by, AT&T, WC Docket 01-338, (Nov. 14, 2002, Jan. 22, 2003, and Feb. 12, 2003).

<sup>17</sup> *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, and Deployment of Wireline Services Offering Advanced Telecommunications Capability*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, CC Dockets Nos. 01-338, 96-98, and 98-147, Released: August 21, 2003, ¶109. At the end of this paragraph, the Commission concludes, "A market power analysis might be appropriate if the only goal of the Act were to drive prices to cost, but that approach disregards the Act's other goals of

The Commission then goes on to make two other key holdings regarding the use of the *Horizontal Merger Guidelines* in the impairment analysis:

We also decline to adopt a standard that equates or hinges a requesting carrier's impairment with an incumbent LEC's market power in the wholesale market for the input in question.<sup>18</sup>

We disagree with commenters that suggest that we should adopt the HMG's analysis of "committed entry" as our "impair" standard.<sup>19</sup>

The Commission's impairment standard asks whether the lack of access to an incumbent LEC network element poses barriers to entry, including operational and economic barriers, that are likely to make entry into a market uneconomic. The *Horizontal Merger Guidelines* entry standards asks "whether timely and likely entry would be sufficient to return market prices to their premerger levels."<sup>20</sup> The Applicants have missed the simple but fundamental point that the "entry" considered by the Commission is *not* into the provision of wholesale local access services, but rather into the provision of a retail telecommunications service that uses wholesale local access facilities as inputs. In contrast, the *Horizontal Merger Guidelines* entry standard applies to entry into the provision of wholesale local access facilities.

To elaborate, suppose a given local access circuit was deemed "unimpaired" prior to the proposed merger. Now suppose the merger results in higher wholesale local access prices. The *Horizontal Merger Guidelines* standard for committed entry asks whether entry in the market for wholesale local access will be sufficient to return market prices for wholesale local access to their pre-merger levels. The fact that the circuit was not impaired prior to the merger says nothing about the timeliness and profitability of entry into the wholesale market for local access facilities. With this understanding, it is readily apparent that the Applicants' continued reliance on the impairment standard is a *non sequitur*. A finding by the Commission that entry into the provision of a retail telecommunications service is economic at prevailing wholesale local access

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encouraging the deployment of alternative facilities and new technologies and reducing regulation."

<sup>18</sup> *Id.* at ¶110.

<sup>19</sup> *Id.* at ¶111. In addition to the crucial conclusion that different markets are addressed by the impairment standard and the *Horizontal Merger Guidelines*, the Commission here provides the following reasons for its holding. "First, in contrast to the HMG, we are not considering whether new competitors will enter the market in response to a 'small but significant and nontransitory' price rise, nor do we assume that incumbent LECs will be ceding a portion of the market to competitors due to this price rise. Second, contrary to commenters' urgings as discussed above, our impairment analysis does not share the HMG's goal of determining whether committed entry will check incumbents' market power. Third, the HMG do not take into consideration the other goals we do here – particularly encouraging investment in new facilities by both incumbent LECs and others – or the costs of unbundling that the courts have pointed out to us."

<sup>20</sup> *Horizontal Merger Guidelines* § 3.

prices (so that the entrant is not impaired with respect to a LEC network element) certainly does not mean that entry into that retail market would be economic if the merger caused wholesale local access prices to increase.

### III. Unilateral Effects

Applicants have provided limited information about the extent of AT&T's local facilities and wholesale revenues but, despite having data regarding AT&T's wholesale circuit purchases and sales, have never provided econometric analyses of the price effects of the proposed merger on the local wholesale market.<sup>21</sup> Again, mere broad brush statistics without accompanying rigorous analysis based upon these statistics tell the Commission nothing about the effects of the merger under the Commission's established standards for merger review.<sup>22</sup> Consequently, the Applicants have failed to meet their burden of proof.

In contrast, Joint CLECs have provided the Commission with preliminary economic analyses of actual bid submissions and prices contained in Master Service Agreements for the provision of circuits in the local wholesale market.<sup>23</sup> These analyses indicate that AT&T and MCI are the two most frequent offerors of local wholesale circuits, that each offers these as both Type I and Type II circuits, and that their presence significantly lowers prices. More specifically, the August 1, 2005 *Wilkie Ex Parte Presentation* provided the following summary results:

Data from bids to provide circuits to CLECs demonstrate that AT&T and MCI are very active participants. In two auctions last year for transport circuits in SBC and VZ territories, using Type I and Type II circuits, AT&T bid to provide 80% of the total number of circuits in SBC territory and 69% in Verizon, and MCI bid for 91% of the total in SBC territory and 80% in Verizon.

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<sup>21</sup> In the Letter from Gary Phillips of SBC and Lawrence Lafaro of AT&T to Marlene Dortch of the FCC, dated June 24, 2005, and filed in WC Docket No. 05-65 (*"Applicants' June 24, 2005 Letter"*), at p. 7, the Applicants state AT&T's preliminary analysis of its own wholesale local private lines sales and its purchases from other CLECs "confirms that AT&T is charging *more*, on average, than it is paying to other CLECs that offer such services." While this statement has the patina of validity, what underlies it is fool's gold. (As the old saying goes, "A person could drown in water that's on average 1 foot deep.") The Applicants statement – made without the benefit of any commonly-used econometric and statistical analyses – cannot be given any credence in the context of a merger review.

<sup>22</sup> A Memorandum of Ex Parte Communication from James C. Smith of SBC, dated August 29, 2005, and filed in WC Docket No. 05-65 states that "AT&T is a competitively insignificant supplier of wholesale special access services." Since this assertion is not accompanied by any new evidence or analysis, it is presumably based on the Applicants previously filed anecdotal information which lacked any of the necessary economic and statistical analysis. As such, it has no real evidentiary value.

<sup>23</sup> See *Wilkie Ex Parte Presentations*, June 15, 2005, pp. 20-25, and August 1, 2005, pp. 5, 10.

AT&T and MCI regularly offer prices for wholesale circuits at anywhere between 35% and 90% below ILEC Special Access “Rack” Rates.

Regression analyses of the bid data from CLECs demonstrate that the removal of AT&T from SBC territory and MCI from VZ territory would result in bid prices increasing anywhere between 11% and 400% depending on the type of circuit.<sup>24</sup>

#### IV. Coordinated Effects

Applicants contend that because SBC is spending so much money to acquire AT&T it has every incentive to use and expand those facilities.<sup>25</sup> They also contend any collusion defies economics.<sup>26</sup> No further analysis is presented.

Joint CLECs have demonstrated that SBC has every incentive to retreat from wholesaling AT&T’s current offerings out-of-region. They have presented the Commission with evidence that SBC has not upheld its commitment made in the SBC-Ameritech merger to compete out-of-region<sup>27</sup> and that where SBC can easily enter Verizon’s Los Angeles and Stamford markets, it has largely refrained from doing so.<sup>28</sup> This behavior is perfectly understandable and economically rational given the great disparity between the returns SBC earns in-region from its special access services and the much lower returns it would earn from competing out-of-region.

To elaborate, economists have long understood the possibilities of “Mutual Forbearance” or “Tacit Collusion,” where two or more firms voluntarily refrain from competing with one another in order to preserve supra-competitive prices. The conditions under which the strategy of tacit collusion is an equilibrium in the market place depends on the values of the following variables: (1) the level of profits made by each firm under mutual forbearance; (2) the level of profits under competition; (3) the size and duration of the gain from “cheating and competing” in violation of the collusion; (4) the number of firms; and (5) the discount factor (the cost of capital) that is used to discount future earnings.<sup>29</sup> The formula is as follows:

Tacit collusion is an equilibrium when (a) the discounted net present value of the stream of earnings from collusion is higher than the sum of (b) the “one-shot”

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<sup>24</sup> *Id.* p. 5.

<sup>25</sup> *Applicants’ June 24, 2005 Letter*, p. 11.

<sup>26</sup> *Id.* n. 48.

<sup>27</sup> Petition to Deny of Cbeyond Communications, Conversent Communications, Eschelon Telecom, Nuvox Communications, TDS Metrocom, XO Communications, and Xspedius Communications, dated April 25, 2005, and filed in WC Docket No. 05-65, pp.48-51.

<sup>28</sup> See *Wilkie Ex Parte Presentations*, June 15, 2005, pp. 30-35, and August 1, 2005, pp. 13-15.

<sup>29</sup> For a standard treatment of the discount factor, see any Industrial Organization text book, such as Jean Tirole (1988), “The Theory of Industrial Organization,” MIT Press.

profits from cheating and competing plus (c) the discounted net present value of the stream of earnings under competition.

This is because the collusion is sustained by the strategy: I will refrain from competing with you as long as you refrain from competing with me, but, if you ever compete with me, then I will compete with you -- and the collusion is permanently ended. Each of the elements in the formula can be easily sized from SBC's current special access revenues and margins and AT&T's revenues and margins from the sales of wholesale circuits. Once the numbers are plugged in, it is evident that the gain from collusion is many times the gain from competing.

### **Conclusion**

The Commission's process for reviewing mergers demands rigor. To recap the filings of the Applicants to date:

No market definition.  
No market concentration/HHI analysis.  
No unilateral price effects analysis.  
No coordinated effects analysis.

For whatever reason, the Applicants somehow cannot bring themselves to comply with these basic building-blocks of merger review. Instead, they launch criticisms and offer information and statistics untethered to well-known legal and economic requirements. These in no way substitute for the rigor required by the FCC and do not meet the burden imposed by the law. Four strikes, and the Applicants are most certainly out!

Sincerely,



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cc: Chairman Kevin Martin  
Commissioner Kathleen Abernathy



Marlene H. Dortch

August 31, 2005

Page 9 of 9

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